



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
TWINE, INC.)

For Appellant: Stephen Ravel
Attorney at Law

For Respondent: Carl G. Knopke
Counsel

O P I N I O N

This appeal is made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Twine, Inc., against a proposed assessment of additional franchise tax in the amount of \$25,794 for the period May 1, 1977, through December 31, 1977.

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The question presented for decision is whether appellant is required to recognize the gain realized from the sale of a partnership interest during the 12-month period following its adoption of a plan of complete liquidation.

Appellant Twine, Inc., was a wholly owned subsidiary of Presentaciones Musicales, S.A. (hereafter "PMSA"), a Panamanian corporation. On December 20, 1976, appellant adopted a plan of complete liquidation under Revenue and Taxation Code sections 24512-24514. On December 12, 1977, appellant sold its partnership interest in Lafayette Properties to 21 Rio Development Company, an unrelated company, for \$325,000. Since appellant had a negative basis of \$110,936 in the partnership, the sale resulted in a realized gain of \$435,936. Following the sale, but before December 20, 1977, appellant made the final distribution of its assets to its parent corporation.

On its final franchise tax return, appellant did not recognize the \$435,936 in gain on the grounds that the sale of its partnership interest occurred during the 12-month period of a plan of complete liquidation adopted under Revenue and Taxation Code section 24512. Respondent determined that appellant was required to recognize the gain because Revenue and Taxation Code section 24514, subdivision (b)(1), provides that non-recognition of such gain is not permitted when the parent corporation does not recognize gain on the receipt of its subsidiary's assets pursuant to a plan of complete liquidation under Revenue and Taxation Code section 24502. Appellant argues that it is entitled to nonrecognition of the gain because section 24514, subdivision (b)(2), governs the transaction rather than section 24514, subdivision (b)(1). Because of the stock basis allocable to the partnership interest, appellant contends that section 24514, subdivision (b)(2), would allow nonrecognition of all the gain.

In order to fully understand the respective positions taken by appellant and respondent, it is necessary to first give a brief overview of four statutes, Revenue and Taxation Code sections 24512, 2450.2, 24514, and 24504, and to explain their interrelationship.

Revenue and Taxation Code section 24512 states that when a corporation adopts a plan of complete liquidation and distributes its assets within the 12-month period beginning on the date of the adoption of the

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plan, then the corporation will recognize no gain or loss from the sale or exchange of its property within the 12-month period. The effect of this section is to eliminate any tax at the corporate level and tax only the shareholders on liquidation.

Revenue and Taxation Code section 24502 provides that if certain conditions are met, a parent corporation will not recognize gain or loss on the receipt of property distributed in complete liquidation of a subsidiary. Briefly, these conditions are: (1) the corporation receiving the property must own at least 80 percent of the distributing corporation's stock; (2) there must be a complete cancellation or redemption of all of the stock of the distributing corporation; and (3) the transfer of the property **must** occur within certain time limits. The parties agree that appellant's liquidation met the requirements of section 24502.

Up to this point, the combination of sections 24512 and 24502 would allow nonrecognition of gain at both the corporate level (subsidiary) and the shareholder level (parent) under a qualified liquidation. However, Revenue and Taxation Code section 24514, subdivision (b)(2), provides that section 24512 does not apply to the liquidation of a subsidiary corporation under section 24502 when the parent's basis in the subsidiary's assets is determined under Revenue and Taxation Code section 24504, subdivision (b)(1). Section 24504 governs the basis of property received in liquidations. Section 24504, subdivision (b)(1), provides that a corporation receiving assets in a section 24502 liquidation takes them at the basis they had in the hands of the transferor, except when section 24504, subdivision (b)(2), is applicable. Section 24504, subdivision (b)(2), provides that if its terms are met, then the distributee's basis in the property will be the adjusted basis of the stock with respect to which the distribution was made. Thus, section 24504, subdivision (b)(1), provides for a carryover basis, and **section** 24504, subdivision (b)(2), provides for a cost basis.

This brings us to the crux of the dispute between the parties. Respondent contends that **PMSA's** basis in appellant's assets is governed by the carryover basis provision of section 24504, subdivision (b)(1). This means that the limitation provision of section 24514, subdivision (b)(1), operates to deny appellant the nonrecognition provision of section 24512. Appellant, on the other hand, contends that PMSA's basis in appellant's

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assets is governed by the cost basis provision of section 24504, subdivision (b)(2). Because of the stock basis it has allocated to the partnership interest, appellant contends that section 24514, subdivision (b) (2), would operate to allow nonrecognition of its gain.^{1/} Thus, we must determine whether PMSA's basis in appellant's property is properly computed under section 24504, subdivision (b)(1) or subdivision (b)(2).

As discussed above, section 24504, subdivision (b)(1), provides for a carryover basis, while subdivision (b)(2) provides for a cost basis.^{2/} "To qualify for cost treatment, subdivision (b)(2) requires that the stock of the subsequently liquidated corporation be acquired by "purchase." Section 24504, subdivision (b)(3), defines "purchase" for the purposes of (b)(2) in subparagraphs (A), (B), and (C). Subparagraph (C) provides that "purchase" does not include stock "acquired from a person the ownership of whose stock would, under Section 24497(a), be attributed to the person acquiring such stock." Respondent contends that under Revenue and Taxation Code section 24497, subdivision (a)(2)(A), appellant's stock was attributable to PMSA at the time PMSA acquired appellant's stock; therefore, the stock was not "purchased" for the purposes of section 24504, subdivision (b)(2).

^{1/} In the appeal year, Revenue and Taxation Code section 24514 read in pertinent part:

(b) In the case of a sale or exchange following the adoption of a plan of complete liquidation, if Section 24502 applies with respect to such liquidation, then

(1) If the basis of the property of the liquidating corporation in the hands of the distributee is determined under Section 24504 (b)(1), this section and Sections 24512 and 24513 shall not apply; or

(2) If the basis of the property of the liquidating corporation in the hands of the distributee is determined under Section 24504 (b)(2), this section and Sections 24512 and 24513 shall apply only to that portion (if any) of the gain which is not greater than the excess of (A) that portion of the adjusted basis (adjusted for any adjustment required under the

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In the appeal year, Revenue and Taxation Code section 24497, subdivision (a)(2)(A), provided in pertinent part:

(2) If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, then--

(A) Such person shall be considered as owning the stock owned ... by or for that corporation, . ..

1/ Cont.

second sentence of Section 24504(b)(2)) of the stock of the liquidating corporation which is allocable, under regulations prescribed by the Franchise Tax Board, to the property sold or exchanged, over (B) the adjusted basis, in the hands of the liquidating corporation, of the property sold **or** exchanged.

2/ Revenue and Taxation Code section 24504, subdivision (b), states, in part:

(b)(1) If property is received by a corporation in a distribution in complete liquidation of **another corporation** (within the meaning of Section 24502(b)), then except as provided in paragraph (2), the basis of the property in the hands of the distributee shall be the same as it would be in the hands of the transferor. If the property is received by a corporation in a transfer to which Section 24502(c) applies, and if paragraph (2) of this subdivision does not apply, then the basis of the property in the hands of the transferee shall be the same as it would be in the hands of the transferor.

(2) If property is received by a corporation in a distribution in complete liquidation of another corporation (within the meaning of Section 24502(b)), and if--

(A) The distribution is pursuant to a plan of liquidation adopted--

(i) On or after December 31, 1954; and

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Respondent contends that appellant's tax return for the income year ended April 30, 1974, and each subsequent tax return until the sale at issue, shows that PMSA was the sole shareholder of California Aesthetics, Ltd., appellant's sole shareholder. Further, appellant's tax return for income year ended 1977 reported that appellant's new

2/ Cont.

(ii) No more than two years after the date of the transaction described in subparagraph (B) (or, in the case of a series of transactions, the date of the last such transaction); and

(B) Stock of the distributing corporation possessing at least 80 percent of the total **combined** voting power of **all** classes of stock entitled to vote, and at least 80 percent of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends), was acquired by the distributee by purchase (as defined in paragraph (3) during a **12-month** period beginning with the earlier of--

(i) The date of the first acquisition by purchase of such stock, or

(ii) If any of such stock was acquired in an acquisition which is a purchase within the meaning of the second sentence of paragraph (3), the date on which the distributee is first considered under section .24497(a) as owning stock owned by the corporation from which such acquisition was made

then the basis of **the property** in the hands of the distributee **shall** be the adjusted basis of the stock with respect to which **the** distribution was made. . . .

(3) For purposes of paragraph (2)(B), the term "purchase" means any **acquisition** of stock, but only if--

* * *

(C) The stock is not acquired from a person the ownership of whose stock would, under Section 24497(a), be attributed to the person acquiring such stock.

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parent, PMSA, was still the sole shareholder of appellant's prior parent, California Aesthetics, Ltd. Thus respondent contends that appellant's new parent bought appellant from its own subsidiary. Appellant does not dispute these facts.

We find that PMSA constructively owned appellant by virtue of its 100-percent ownership of California Aesthetics, Ltd. Therefore, its acquisition of appellant's stock was not a "purchase" under section 24504, subdivision (b)(2), and its basis must be determined according to section 24504, subdivision (b)(1). Since the basis of the stock is determined according to section 24504, subdivision (b)(1), section 24514, subdivision (b)(1), is applicable, and appellant does not qualify for nonrecognition on the sale of its assets under section 24512.

Appellant argues, in the alternative, that it is entitled to nonrecognition of gain because PMSA failed to secure an advance ruling under Revenue and Taxation Code section 24561. Section 24561 provides that in certain specified corporate transfers, including complete liquidations of subsidiaries, a foreign corporation will not be considered a "corporation" in determining the extent gain is recognized unless there is a showing to the Franchise Tax Board that the transfer is not in pursuance of a plan having as one of its principal purposes the avoidance of taxes. Appellant contends that because no ruling was obtained, PMSA cannot be considered a corporation. Therefore, appellant maintains that section 24502 does not apply to the liquidation. If section 24502 does not apply, then the limitation of section 24514, subdivision (b)(1), also does not apply, and, under section 24512, appellant's gain will not be recognized.

Respondent replies that section 24561 was enacted to combat tax avoidance through the use of foreign corporations and was not intended to provide an additional vehicle for tax avoidance.

In Revenue Ruling 76-90, 1976-1 Cum. Bull. 101, the Internal Revenue Service was presented with the identical argument propounded by appellant. The Service concluded that section 367 of the Internal Revenue Code, the federal counterpart to section 24561, was not intended to allow taxpayers an option to escape tax consequences that would otherwise follow but for the application of that section. The Service ruled that a

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subsidiary is not entitled to **utilize** the failure to secure an advance ruling under section ,367 to avoid **recognition** of gain on the sale of an asset pursuant to a plan of complete liquidation. We agree with this conclusion. Further, temporary Treasury regulation section 7.367(a)-1(g) provides:

Failure of the **taxpayer** to request a ruling under section 3,67(a)(f) may not be **used** by the **taxpayer** to its advantage. In those situations which the Commissioner deems appropriate, a foreign corporation will be treated as a corporation even in the absence of a ruling request.

Regulations under the Internal Revenue Code govern the interpretation of conforming state statutes in the absence of **regulations** of the Franchise Tax Board. (Cal. Admin. Code, tit. 18, § 26422.) We sustain respondent's determination that appellant be **treated** as a corporation. Therefore, section 24502 is applicable, and the gain from appellant's sale is **subject** to the limitation of section 24514, subdivision (b);(1).

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O_R_D_E_R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Twine, Inc., against a proposed assessment of additional franchise tax in the amount of \$25,794 for the period May 1, 1977, through December 31, 1977, be and the same is hereby sustained.

Done at Sacramento, California, this **12th** day Of September , 1984, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Dronenburg, Mr. Collis and Mr. Bennett present.

Richard Nevins _____, Chairman
Ernest J. Dronenburg, Jr. _____, Member
Conway H. Collis _____, Member
- William M. Bennett _____, Member
- - - - - _____ - - _____, Member